SUPREME COURT, U. S.

Supreme Court
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MICHAEL RODAK,

IN THE

Supreme Court of the United States

No. 72-1245

ST. LOUIS-SAN FRANCISCO RAILWAY COMPANY,
Petitioner

v.

UNITED STATES OF AMERICA, *Respondent*

PETITION FOR A WRIT OF CERTIORARI TO UNITED STATES COURT OF CLAIMS

ROBERT T. MOLLOY
Rosslyn Building, North
1911 Fort Myer Drive
Arlington, Virginia 22209
Attorney for Petitioner

Of Counsel:

GEORGE E. BAILEY
906 Olive Street
St. Louis, Missouri 63101

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TABLE OF CONTENTS

	Page
Opinion Below	1
Jurisdiction	1
Questions Presented	2
Statutes and Regulations Involved	2
Statement	3
Reasons for Granting Writ	8
Conclusion	18
Appendix:	
A. Statutes and Regulations	A-1
B. Opinion and Judgment Below	B-1, C-1

TABLE OF AUTHORITIES

Cases:

American Smelting & Refining Co. v. United States, 130 F.2d 883 (3d Cir. 1942) 8, 10

Arkansas-Missouri Power Corp. v. Paschal, 243 F.2d 584 (8th Cir. 1957), *cert. denied*, 355 U.S. 835 (1957) 17

Atchison, Topeka and Santa Fe R.R. v. United States, 443 F.2d 147 (10th Cir. 1971) 8, 10, 14

Bethlehem Steel Corp. v. United States, 434 F.2d 1357 (Ct. Cl. 1970) 5, 15, 16

Chicago, Milwaukee, St. Paul & Pacific R.R. v. United States, 404 F.2d 960 (1968) 8, 17

Cities Service Co. v. United States, 316 F.Supp. 61 (S.D.N.Y. 1970) 10, 14

Claussen's, Inc. v. United States, Civil No. 1350 (S.D. Ga., July 29, 1971), *reversed and remanded*, 469 F.2d 340 (5th Cir. 1972) (72-2 USTC 9751) 11, 14

Page

Commissioner v. Danielson, 378 F.2d 771 (3d Cir. 1967), *cert. denied,* 389 U.S. 858 (1967) 5, 15, 16
Copperhead Coal Co. v. Commissioner, 272 F.2d 45 (6th Cir. 1959) 11
Erie Lackawanna R.R. v. United States, 422 F.2d 425 (Ct. Cl. 1970) 4, 6, 8, 9, 12
Great Western Power Co. of California v. Commissioner, 299 U.S. 543 (1936) 17, 18
Missouri Pacific R.R. v. United States, 427 F.2d 727 (Ct. Cl. 1970), *modified on reconsideration,* 433 F.2d 1324 (Ct. Cl. 1970), *cert. denied,* 402 U.S. 944 (1971) 4, 6, 8, 9, 13
Montana Power Co. v. United States, 232 F.2d 541 (3d Cir. 1956), *cert. denied,* 358 U.S. 842 (1958) 13
Nassau Lens Co. v. Commissioner, 308 F.2d 39 (2d Cir. 1962) 10
National Alfalfa Dehydrating and Milling Company v. Commissioner of Internal Revenue, (10th Cir. 1973) (73-1 USTC 9194) 8, 9, 14, 15
Natural Gas Pipeline Co. of America, 45 B.T.A. 939 (1941) 11, 17
United States v. Davis, 370 U.S. 65 (1962) 11

STATUTES:

Bankruptcy Act, Section 77, 11 U.S.C. Section 205 (1964) 5, 6, 14

Internal Revenue Code of 1954, 26 U.S.C. (1964):
Section 83 11
Section 108(a) B-2, B-4, C-7
Section 119 11
Section 163 .....2, A-1
Section 334(b) 11
Section 351(b) 11
Section 356 11
Section 358 11
Section 362 11
Section 368(a)(1)(E) 3
Section 372 11
Section 373 11
Section 374 11

Page

Section 381 11
Section 1001(b) 11
Section 1017 ..... B-3, B-4, B-8, B-9
Section 1031(b) 11
Section 1033(e) 11
Section 1034(e) 11
Section 1038 11
Section 1071 11
Section 1081(b) 11
Section 1102 11
Section 2031(p) 12
Section 7422(a) C-9

Tax Reform Act of 1969, Section 1232(b), 26 U.S.C. Section 1232(b) (1970) 12

MISCELLANEOUS:

Treasury Regulations on Income Tax (26 C.F.R.): Section 1.163-3 (1968) 3, A-1
Section 1017-1(b)(7) (1957) B-4

Treasury Regulations on Estate Taxation (26 C.F.R.): Section 20.2031-2(b) (1958) 12

Treasury Regulations on Gifts Taxation (26 C.F.R.): Section 25.2512-2 (1958) 12

IN THE

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ST. LOUIS-SAN FRANCISCO RAILWAY COMPANY,
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v.

UNITED STATES OF AMERICA, *Respondent*

PETITION FOR A WRIT OF CERTIORARI TO UNITED STATES COURT OF CLAIMS

St. Louis-San Francisco Railway Company prays that a writ of certiorari be issued to review the judgment of the United States Court of Claims entered in the above-titled case on December 12, 1972.

CITATION TO OPINION BELOW

The opinion of the Court of Claims, dated December 12, 1972, (Appendix B-1) is reported at — Fed. 2nd —. The related opinion of the Court of Claims dated July 14, 1971 (Appendix C) is reported at 444 F.2d 1102 (1971).

JURISDICTION

The judgment of the Court of Claims was entered on December 12, 1972. The jurisdiction of this Court rests on 28 U.S.C. Section 1255(1).

QUESTIONS PRESENTED[1]

1. When a corporation issues debentures in exchange for its preferred stock having a market value less than the face amount of the debentures, does the difference between the market value of the preferred stock and the face amount of the debentures constitute additional interest amortizable over the life of the debentures.

2. When a corporation issues new bonds in exchange for its old bonds having a market value less than the face amount of the new bonds, does the difference between the market value of the old bonds and the face amount of the new bonds constitute additional interest amortizable over the life of the new bonds.

3. Whether any portion of the amortizable debt discount and expense attributable to outstanding debt securities may be carried over and amortized over the life of new debt securities issued in exchange therefor in a reorganization of a corporation involving the issuance of new stock and debt securities for the previously outstanding debt securities.

STATUTES AND REGULATIONS INVOLVED

The statutory provisions involved are Section 163 of the Internal Revenue Code of 1954 (26 U.S.C. Sec-

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[1] The court below granted respondent's motion for summary judgment with respect to Questions 1 and 2 on the ground that the questions involved previously had been determined adversely to petitioner in *St. Louis-San Francisco Railway Company* v. *United States*, 444 F.2d 1102 (1971) (Appendix C-1). That case came before the Court of Claims on cross motions for summary judgment with respect to issues raised by the petitioner in its Court of Claims petition. The instant case came before the Court of Claims on cross motions for summary judgment involving, in part, issues raised by petitioner as offsets to offsets.

tion 163) and Income Tax Regulations Section 1.163-3 promulgated by the United States Department of the Treasury. These sections are printed in Appendix A, *infra*, at A-1.

STATEMENT

Petitioner is a corporation organized and existing under the laws of the State of Missouri, and has its principal offices located in St. Louis. At all times here pertinent, petitioner was engaged in operating as a common carrier by rail in interstate commerce and employed the accrual method of accounting.

1. In 1956, petitioner exchanged Series A, 5% Income Debentures bearing a maturity date of January 1, 2006, plus cash and common stock for a part of its outstanding Series A, 5% Preferred Stock, issued in its 1947 reorganization. The Internal Revenue Service ruled that this exchange was a reorganization under Section 368(a)(1)(E) of the Internal Revenue Code of 1954. It also ruled that gain, if any, was recognizable to the exchanging preferred stockholders measured by the excess of the aggregate fair market value of the securities and cash received over the tax basis of the preferred stock surrendered. For each $100 par value share of preferred stock surrendered, the holders of the preferred stock received a $100 maturity value Series A Debenture and one quarter share of common stock. They also received $5.00 cash for the dividend on the preferred stock which would have been due at the next dividend payment date had the preferred stockholder not surrendered his stock. In the aggregate, petitioner issued new debentures having face value of $33,129,000, 82,823 shares of no par value common stock and cash in exchange for 331,290 shares of preferred stock, hav-

ing a total par value of $33,129,000 but a market value, based on New York Stock Exchange quotations, of $22,908,148.35. Petitioner contends that it should be entitled to amortize as additional interest the difference between the maturity value ($33,129,000) of new debentures issued and the fair market value of the preferred stock ($22,908,148.35) received in exchange for the new debentures as debt discount, and in any event, that it sustained debt discount upon the exchange to the extent of the value of the common stock and cash given up in the exchange.

The court below held that petitioner was not entitled to amortize the difference between the maturity value of the new debt securities and the fair market value of the preferred stock nor did petitioner sustain debt discount to the extent of the value of the common stock given up in the exchange. The basis for the ruling was that where the maturity value of the new debt did not exceed the par value of the old preferred stock received in exchange for the new debt, no debt discount can arise and, alternatively, by holding that the value to petitioner of the preferred stock received in the exchange for the debentures was significantly greater than what was initially paid in for the stock or its market value, relying upon its prior decisions in *Erie Lackawanna R.R.* v. *United States,* 422 F.2d 425 (Ct. Cl. 1970), and *Missouri Pacific R.R.* v. *United States,* 427F.2d 727 (Ct. Cl. 1970), *modified on reconsideration,* 433 F.2d 1324 (1970), *cert. denied,* 402 U.S. 944 (1971). In addition, the court held that petitioner was not entitled to amortize debt discount measured by the value of the common stock given up in the exchange because common stock has no value in determining debt discount and, alternatively, because "it is very

difficult to assume that the preferred stockholders who surrendered their preferred shares in 1956 for the debentures believed, or had any reason to believe, that they were realizing additional interest income through the exchange (because of a debt discount due to the issuance of the common stock)." Opinion, *infra*, Appendix, at C-6, 7. The court concluded that petitioner was altering or repudiating its bargain to the detriment of the stockholders by seeking a tax deduction for the discount, citing *Bethlehem Steel Corp.* v. *United States*, 434 F.2d 1357 (Ct. Cl. 1970), and *Commissioner* v. *Danielson*, 378 F.2d 771 (3d Cir. 1967). No consideration was given by the court below to the cash consideration paid.

2. Petitioner was reorganized, effective January 1, 1947, pursuant to a plan of reorganization approved by the Interstate Commerce Commission and the Federal District Court having jurisdiction over petitioner's trusteeship under Section 77 of the Federal Bankruptcy Act, 11 U.S.C. Section 205 (1964). Under this reorganization plan, the outstanding common and preferred stock and the claims of unsecured creditors were eliminated as worthless and the holders of the several classes of long-term indebtedness and the bank creditors received new bonds, preferred stock, common stock and cash. Under the plan of reorganization petitioner issued new 4% First Mortgage Bonds and 4½% Second Mortgage Bonds having an aggregate maturity value of $120,935,000 but a market value, established by New York Stock Exchange quotations, totaling $91,866,411 in exchange for the outstanding old secured debt. Petitioner contends that it is entitled to amortize the difference of $29,068,589 between the maturity value of the new bonds and the fair market value of the

old bonds as additional interest over the life of the new securities.

The court below held, in effect, that the difference between the maturity value of the new bonds and the fair market value of the old bonds did not constitute additional interest amortizable over the life of the new bonds "because the maturity value of the new debt did not exceed the maturity value of the old debt." The court below relied upon its prior decisions in *Erie Lackawanna R.R.* v. *United States,* 422 F.2d 425 (Ct. Cl. 1970), and *Missouri Pacific R.R.* v. *United States,* 427 F.2d 727 (Ct. Cl. 1970), *modified on reconsideration,* 433 F.2d 1324 (Ct. Cl. 1970), *cert. denied,* 301 U.S. 944 (1971).

3. In 1947, petitioner underwent a reorganization pursuant to Section 77 of the Bankruptcy Act. Under the approved plan as finally adopted by the Interstate Commerce Commission (ICC) and the Courts, petitioner exchanged new bonds, new stock, and cash for old debt securities, stock, bank loans, and accrued interest. At the time of such reorganization (January 1, 1947), petitioner had an old extant debt on which there remained unamortized debt discount and issuance expense as follows:

Debt Security	Unamortized Debt Discount and Expense
Prior Lien 4% Bonds, Series A	$ 224,903.00
Prior Lien 5% Bonds, Series B	2,214.00
Consolidated 4½% Bonds, Series A	4,182,322.00
Consolidated 6% Bonds, Series B	8.33
Total	$4,409,447.33

All of the above-listed debt had been issued by plaintiff between 1916 and 1947 for cash. For example, in 1928, the ICC, by Finance Docket No. 6798-1928, 138 ICC 505, granted petitioner authority to sell $108,000,000 of its Consolidated 4½% Bonds, Series A, at a discounted price of 94½; and such sale was duly consummated, with the result that petitioner suffered actual cash discount in excess of $4,000,000.

In the course of the audit of petitioner's income tax returns for the years immediately following its 1947 reorganization, the Internal Revenue Service allocated the pre-reorganization unamortized debt discount to interest, the new common stock, preferred stock and debt securities. Such allocation was made by determining the percentage of new bonds issued in exchange for interest, common stock, preferred stock and the old debt securities and applying the percentages to the total unamortized discount. The amounts allocated to the new debt securities were as follows:

New Debt Securities	Old Unamortized Discount and Expense Allocated
4% First Mortgage Bonds	$ 969,605.41
4½% Second Mortgage Bonds	684,005.41
Total	$1,653,610.82

The Internal Revenue Service allowed petitioner's deductions for amortization of the allocated carryover discount for the years 1947 through 1965. The balance of the carryover discount, deemed to be attributable to interest and the stocks issued in the 1947 reorganization, was "washed out" and no deductions have ever been claimed or allowed with respect thereto.

In the court below the respondent asserted as an offset that the amortization deductions for the years 1953 through 1962 were improperly allowed and the court sustained respondent's contention on the ground that the issue was governed by its decision in *Chicago, Milwaukee, St. Paul and Pacific R.R.* v. *United States,* 186 Ct. Cl. 250, 404 F.2d 960 (1968).

REASONS FOR GRANTING THE WRIT

I. The 1947 Reorganization and the 1956 Exchange

1. The decision of the court below is in direct conflict with the decisions of the Tenth Circuit Court of Appeals in *National Alfalfa Dehydrating and Milling Company* v. *Commissioner of Internal Revenue,* —— F.2d —— (10th Cir. January 26, 1973) (73-1 USTC 9194) and in *Atchison, Topeka and Santa Fe R.R.* v. *United States,* 443 F.2d 147 (10th Cir. 1971), and of the Third Circuit Court of Appeals in *American Smelting & Refining Co.* v. *United States,* 130 F.2d 883 (3d Cir. 1942).

In *National Alfalfa,* the taxpayer delivered to each of its preferred stockholders one $50 five percent debenture in exchange for each share of preferred stock held by such stockholders. At the time of such exchange, the fair market value of the preferred stock was $33 per share. The court, reversing the Tax Court, expressly rejected the Court of Claims decisions in *Erie Lackawanna R.R.* v. *United States,* 422 F.2d 425 (Ct. Cl. 1970), and *Missouri Pacific R.R.* v. *United States,* 427 F.2d 727 (Ct. Cl. 1970) and held that each of the debentures were issued at a discount of $17 and that the aggregate amount of such discount was deductible by the taxpayer, as additional interest, pro-rata over the life of the debentures. The facts in *National Alfal-*

fa are, for all practical purposes, identical to the facts underlying the first of the questions presented in this petition; and it is beyond question that there is a direct conflict that should be resolved by this Court. Further, the reasoning and the conclusion of *National Alfalfa* are irreconcilable with the decision of the court below with respect to petitioner's right to amortize and deduct as interest the difference between the market value of its old bonds and the face amount of the new bonds issued in exchange therefor in its 1947 reorganization. The decisions [2] by the lower court which are relied upon by the lower court to support its decision in the present case are based upon an erroneous premise, namely, that the question is not whether there was debt discount which served the purpose of stated interest, but whether there was a loss suffered.

In its brief (page 10) in opposition to petitioner's earlier petition for certiorari (*St. Louis-San Francisco Ry.* v. *United States,* Sup. Ct. Dkt. No. 71-522) on the debt discount issues involved in the present case, defendant, anticipating the possibility of conflict from the Tenth Circuit Court of Appeals by its decision in *National Alfalfa,* stated:

> To the extent, therefore, that petitioner relies on the views of the Tenth Circuit to establish conflict, it will be time enough to consider whether review by this Court is appropriate if the decision in *National Alfalfa* is reversed.

The Tax Court's decision in *National Alfalfa* has now been reversed, the conflict has now become a fact, and the debt discount issues presented by this pro-

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[2] *Erie Lackawanna R.R.* v. *United States* and *Missouri Pacific R.R.* v. *United States, supra.*

ceeding are in dire need of review and decision by this Court.

In *Atchison, Topeka and Santa Fe* the taxpayer had issued bonds in exchange for the intangible claims of the general mortgage bondholders of a bankrupt predecessor company and the Government argued that debt discount does not arise in a bonds-for-property exchange. The court held, however, that debt discount could arise in such an exchange, citing *American Smelting & Refining Co., supra,* and *Nassau Lens Co.* v. *United States,* 308 F.2d 39 (2d Cir. 1962). In *American Smelting, supra* [3], the Third Circuit concluded that bonds issued in a face amount greater than the fair market value of the securities of its subsidiary, for which they were issued, gave rise to amortizable discount in the amount of such difference.

The decision of the court below is also in direct conflict with the decision of the Second Circuit Court of Appeals in *Nassau Lens Co.* v. *Commissioner,* 308 F.2d 39 (2d Cir. 1962).

The decision of the District Court in *Cities Service Co.* v. *United States,* 316 F.Supp. 61 (S.D.N.Y. 1970), now pending on appeal in CA-2, further confuses this area of Federal tax law In *Cities Service* the court held that debt discount can arise where the face amount of bonds issued for property is greater than the market value of the property acquired. However, where the property acquired is the issuer's own stock, a different rule is applied; and no discount is allowed unless the

[3] Subject case was also followed in *Southern Fertilizer & Chemical Co.* v. *Edwards, U.S.D.C., M.D. Ga.,* 167 F.Supp. 879 (1955) and *Industrial Development Corp.* v. *United States,* D. Ill., 51 AFTR 1514 (1956).

issue price of the stock received in the exchange (i.e., the amount originally received upon the issuance of such stock) is less than the maturity value of the debentures issued in the exchange. See also *Claussen's, Inc.* v. *United States,* Civil No. 1350 (S.D. Ga., July 29, 1971), reversed and remanded, 469 F.2d 340 (5th Cir. 11/16/72) (72-2 USTC 9751).

The decision of the court below is in conflict with the basic long standing principle of the tax law that property received in an exchange is to be valued at its fair market value. See, e.g., *United States* v. *Davis,* 370 U.S. 65 (1962); Internal Revenue Code of 1954, 26 U.S.C. Sections 83, 119, 351(b), 356, 1001(b), 1031(b), 1038, and 1081(b). Where Congress has intended another standard to apply, it was expressly so stated. See, e.g., *id., sections* 334(b), 358, 362, 372, 373, 374, 381, 1031(b), 1033(e), 1034(e), 1071, 1081, and 1102. The court below has created a new exception without legislative sanction and in conflict with other judicial pronouncements establishing the general rule that fair market value is to be consulted in determining what is received in an exchange for purposes of measuring debt discount.

The court below again failed to recognize fair market value as a standard in the 1956 exchange when it failed to allocate the value of the preferred stock received in the exchange between the obligations, the common stock and the other element of the exchange, i.e., cash. *Natural Gas Pipeline Co. of America,* 45 B.T.A. 939 (1941); *cf. Copperhead Coal Co.* v. *Commissioner,* 272 F.2d 45 (6th Cir. 1959).

The court below ignored the Internal Revenue Code and the Treasury Department's long standing regula-

tions on valuation by determining that the value of the property received in the exchange was what the property was worth to the issuer, without reference to the market quotations for that property. See Internal Revenue Code of 1954, 26 U.S.C. Section 2031(b) (1964); Treas. Reg. Sections 20.2031(b) and 25.2512-2. The Court of Claims has thus continued its divorce from the use of acceptable standards of the valuation of securities which began in *Erie Lackawanna R.R.* v. *United States,* 422 F.2d 425 (Ct. Cl. 1970), when it adopted the standard of "equitable equivalent" for valuing securities received in an exchange.

This Court should review this case to resolve the conflict between the Court of Claims and the various Circuit Courts of Appeals in the important question of when debt discount arises and how it is measured.

2. The question presented is clearly important to the administration of the tax laws. The strained money market of recent years has made the use of discount more prevalent in financing arrangements, particularly in the railroad industry, because of a lack of incentive for equity investment. The position adopted by the lower court in *St. Louis-San Francisco, supra,* is wholly inconsistent with the long-established Internal Revenue Service rules for determining the value of securities (cf., Internal Revenue Code, 26 U.S.C. Section 2031 (1964), Treas. Reg. Sections 20.2031-2(b) and 25.2512-2(b)). Recently enacted legislation with respect to debt discount (Tax Reform Act of 1969, 26 U.S.C. 1232(b) (1970)) has no effect upon security transactions prior to May 27, 1969. There is a lasting impact on taxpayers due to the fact that transactions not subject to the new legislation remain subject to audit by the Government because maturity dates and

amortization periods of debt discount for securities issued prior to May 27, 1969, will extend for many years into the future and considerable litigation will result until this matter is resolved. See also Brief for United States in Opposition to Petition for Writ of Certiorari at 9, *Missouri Pacific R.R.* v. *United States,* October Term, 1970, No. 1333, *cert. denied,* 402 U.S. 944 (1971).

3. The need to clarify this area of the federal tax law is further pointed up by the decision of the Third Circuit Court of Appeals in *Montana Power Co.* v. *United States,* 232 F.2d 541 (3d Cir. 1956), *cert. denied,* 358 U.S. 842 (1958). This case dealt with the issuance of bonds for certain natural gas properties, and the court concluded that the discount was not available to the taxpayer since the fair market value of the assets for which the bonds were exchanged was not established. During the course of the opinion, in discussing the application of discount amortization to situations in which the securities are issued for property, the seven judges had four different opinions as to when discount was proper. Judges Maris, Goodrich and McLaughlin felt that bond discount was available when bonds were issued in a face amount in excess of the fair market value of the property for which they were exchanged. Judges Kalodner and Staley felt that bond discount was not available where bonds were issued for property. Judge Hastie concluded that the discount was available when the bonds were exchanged for property but only in circumstances of arm's-length dealings. Chief Judge Biggs concluded that discount was available where bonds were issued for property even in the absence of a showing of fair market value of the property if a double tax would result in the absence of the allowance of a deduction for the discount.

The confusion in this area of the tax law, although having ramifications for all types of taxpayers, is particularly injurious to the railroad industry. As indicated by the divergent views and reasoning, relating to the debt discount problem, taken in the recent cases of *National Alfalfa Dehydrating and Milling Company* v. *Commissioner of Internal Revenue,* — F.2d — (10th Cir. 1973) (73-1 USTC 9194), *Atchison, Topeka and Santa Fe R.R.* v. *United States,* 433 F.2d 147 (10th Cir. 1971), *Cities Service Co.* v. *United States,* 316 F.Supp. 61 (S.D.N.Y. 1970), and *Claussen's, Inc.* v. *United States,* Civil No. 1350 (S.D. Ga., July 29, 1971), *reversed and remanded,* 469 F.2d 340 (5th Cir. 1/16/72) (72-2 USTC 9751), the problem is national in scope and requires additional sophisticated review and resolution. Over the years and particularly within the last two decades, a large number of railroads have had to undergo reorganizations in bankruptcy. Indeed, the extent of this phenomenon and the national concern involved finds recognition in the fact that special provisions have been enacted in the Bankruptcy Act (11 U.S.C. Section 205) to handle this class of person. As part of these reorganizations, new securities are invariably issued in exchange for the older outstanding classes of securities, with discount or additional interest being the inducement to the holders of the old securities to agree to the plan. Since discount is indigenous to railroad reorganizations, the tax impact of denying the deductions to the reorganized road during precarious post-reorganization periods defeats the purpose and hope of the reorganization.

The economic effect of the confusion in this area of law is particularly acute at this time due to the general liquidity problem that the railroad industry faces. The

need to set aside funds to pay the additional taxes due from the disallowance of amortization deductions diverts much needed cash from the operation of the roads.

Resolution of this issue would, therefore, have a salutory effect upon an important section of the economy.

4. It is petitioner's belief that the decision of the court below is erroneous and should be corrected by this Court.

The court below has confused debt discount for loss. What is involved here is the additional cost petitioner had to incur in addition to the interest specified in the obligation it was issuing. The additional cost was interest deductible over the life of the obligation. *National Alfalfa Dehydrating and Milling Company* v. *Commissioner of Internal Revenue,* — F.2d — (10th Cir. 1973). The substance of the transaction is no different than the borrowing of money by issuing bonds at a discount followed by the purchase of the old debt or old preferred stock at their respective fair market values. The court below admits that in this latter situation there is discount but refuses to see it where the new obligations are issued directly for the old, with the first step of issuing the bonds for cash being omitted. In treating the bonds and preferred stock of the issuer as a special class of property calling for special tax treatment, the court below has created an arbitrary distinction which confuses this area of tax law.

Reliance by the court below on such cases as *Bethlehem Steel Corp.* v. *United States,* 434 F.2d 1357 (Ct. Cl. 1970), and *Commissioner* v. *Danielson,* 378 F.2d 771

(3d Cir. 1967), *cert. denied,* 389 U.S. 858 (1967), is clearly erroneous and adds further confusion to the bond discount area. Both the *Bethlehem* and *Danielson* cases involved situations in which the tax consequences depended upon the characterizations in written agreements of payments made pursuant to those agreements. Debt discount by its nature is not made pursuant to a written agreement. It occurs simply by virtue of the fact that a purchaser will not pay face value for an obligation with the interest stated in the existing money market. Where a person pays less than the face amount for the bond, whether the medium of payment be money or other property, there is discount without regard to whether or not there is a written agreement to the effect that discount is being paid. Tax consequences flow from economic reality and not from self serving opinions in written agreements.

The court below also erred in refusing to allow petitioner to amortize debt discount on the 1956 exchange measured by the value of the common stock and cash given in the exchange. In the 1956 exchange petitioner in order to induce the preferred stockholders to surrender their preferred stock for the debentures issued one quarter share of common stock and cash with each one hundred dollar ($100) maturity value debenture. The court below ruled that the value of the common stock given in the exchange should be ignored because petitioner made no definite future obligation in issuing such shares. However, common stock is property which has a value and when it is issued with debentures, debt discount exists to the extent of the fair market value of such stock. This is true because a portion of the preferred stock received in the exchange is exchanged for the common stock thereby reducing

the amount of preferred stock received in the exchange for the debenture. *Natural Gas Pipeline Co. of America,* 45 B.T.A. 939 (1941), but see *Arkansas-Missouri Power Corp.* v. *Paschal,* 243 F.2d 584 (8th Cir. 1957), *cert. denied,* 355 U.S. 835 (1957). That principle also applies to the cash. The Court should resolve the conflict between the courts and the confusion on this important question of law.

II. Unamortized Debt Discount Carryover

In the landmark case of *Great Western Power Company of California* v. *Commissioner of Internal Revenue,* 297 U.S. 543 (1936), this Court held that where new bonds were exchanged for old bonds, the remaining unamortized expenses of issuance of the old bonds constituted an expense attributable to the new bonds amortizable annually throughout the term of the new bonds. In the instant case a portion of the new debt securities were issued for the old debt securities and the respondent originally determined that the part of the unamortized discount on the old bonds attributable to the portion of the new bonds exchanged for the old could be amortized over the life of the new bonds. [4] However, in the court below, respondent changed its position and contended that its allowance of amortization deductions was erroneous. The court below sustained respondent's contention on the ground that the issue was governed by its decision in *Chicago, Milwaukee, St. Paul and Pacific R.R.* v. *United States,* 404 F.2d 960 (1968).

It is submitted that the decision in the court below clearly is erroneous and is in conflict with the *Great*

[4] See Statement, pages 7, 8, and 9 of this petition, for the facts pertaining to this issue.

Western case, supra. Great Western stands unequivocally for the proposition that unamortized discount and expense are carried over when new bonds are exchanged for old. The Court of Claims now has emasculated this principle by holding that there is no carryover when new bonds are exchanged for a portion of the old debt and the remaining portion is cancelled. Since the federal question here involved conflicts with an applicable decision of this Court, this issue should be reviewed.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

ROBERT T. MOLLOY
Rosslyn Building, North
1911 Fort Myer Drive
Arlington, Virginia 22209
Attorney for Petitioner

Of Counsel:

GEORGE E. BAILEY
906 Olive Street
St. Louis, Missouri 63101

APPENDIX A

Internal Revenue Code of 1954 (26 U.S.C. 1964 ed.):

§ 163. INTEREST.

(a) GENERAL RULE.—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

Treasury Regulations on Income Tax (26 C.F.R.):

§ 1.163.-3. DEDUCTION FOR BOND DISCOUNT.

(a) Discount upon issuance. (1) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. For purposes of this section, the amortizable bond discount equals the excess of the amount payable at maturity (or, in the case of a callable bond, at the earlier call date) over the issue price of the bond (as defined in paragraph (b)(2) of § 1.1232.-3).

In the United States Court of Claims

No. 289-65
No. 303-66

(Decided December 12, 1972)

ST. LOUIS-SAN FRANCISCO RAILWAY COMPANY v. THE UNITED STATES

Robert E. Simpson for plaintiff. *Robert T. Molloy*, attorney of record. *George E. Bailey*, of counsel.

Frances Foltz Kane, with whom was *Assistant Attorney General Scott P. Crampton*, for defendant. *Fred B. Ugast*, of counsel.

Before COWEN, *Chief Judge*, DAVIS, SKELTON, NICHOLS, KASHIWA, KUNZIG, and BENNETT, *Judges*.

ON PLAINTIFF'S MOTION FOR SUMMARY JUDGMENT AND DEFENDANT'S CROSS-MOTION FOR PARTIAL SUMMARY JUDGMENT

COWEN, *Chief Judge*, delivered the opinion of the court:

In our decision of July 14, 1971 (herein referred to as *St. Louis No. 1*), in these related tax cases, we decided several issues relating to the measurement of debt discount claimed as the result of the exchange of new debt obligations for outstanding debt obligations and outstanding stock. *St. Louis-San Francisco Ry.* v. *United States*, 195 Ct. Cl. 343, 444 F. 2d 1102 (1971), *cert. denied*, 404 U.S. 1017 (1972). The parties' pending cross-motions for summary judgment require us to decide two additional issues that were not raised in the earlier decision and one which both parties now agree is governed by *St. Louis No. 1*.

I

The Reduction of Basis

In *St. Louis No. 1*, we held that because plaintiff had failed to raise the reduction-in-basis issue (as it relates to depreciable property) in its claim for refund, it could not assert the claim on motion for summary judgment. However, this holding did not foreclose plaintiff from asserting the claim as an offset to offsets claimed by defendant. Plaintiff was allowed to file an amended reply to defendant's first amended answer, and plaintiff's current motion is based on this newly pleaded issue.

In 1959, 1960, and 1962, plaintiff reacquired a portion of the debentures that it had issued in 1956 in exchange for outstanding preferred stock. Upon audit, the IRS determined that the reacquisition resulted in a gain, but plaintiff elected to have the gain excluded from its income pursuant to Section 108(a) of the Internal Revenue Code of 1954.[1]

Plaintiff executed Treasury Consent Form 982, which is a prelude to the reduction in the tax basis of certain property to the extent of the unrecognized gain. Section 1017 of the Internal Revenue Code of 1954 is the statutory authority for this reduction.

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[1] SEC. 108. INCOME FROM DISCHARGE OF INDEBTEDNESS.

(a) *Special Rule of Exclusion.*—No amount shall be included in gross income by reason of the discharge in whole or part, within the taxable year, of any indebtedness for which the taxpayer is liable, or subject to which the taxpayer holds property, if—

(1) the indebtedness was incurred or assumed

(A) by a corporation, or

(B) by an individual in connection with property used in his trade or business, and

(2) such taxpayer makes and files a consent to the regulations prescribed under section 1017 (relating to adjustment of basis) then in effect at such time and in such manner as the Secretary or his delegate by regulations prescribes.

In such case, the amount of any income of such taxpayer attributable to any unamortized premium (computed as of the first day of the taxable year in which such discharge occurred) with respect to such indebtedness shall not be included in gross income, and the amount of the deduction attributable to any unamortized discount (computed as of the first day of the taxable year in which such discharge occurred) with respect to such indebtedness shall not be allowed as a deduction.

[We note that § 108(b) does not apply since this was not a discharge, cancellation, or modification affected by an order of a court in a receivership proceeding.]

Plaintiff desired to have the basis of the preferred stock reduced but was rebuffed by the Commissioner. In *St. Louis No. 1* we held that the Commissioner's ruling was correct, because the preferred stock was no longer in existence for the years 1959, 1960, and 1962. The Commissioner did allow a reduction in basis of plaintiff's depreciable property but restricted the reduction to ratably depreciable property. By "ratably depreciable property", we understand that defendant means the kind of property in which the cost or other basis is ratably spread over its estimated useful life during which annual deductions for depreciation are made in accordance with some accounting method such as the straight-line method. In addition to its ratably depreciable property, plaintiff also owns non-ratably depreciable property, *e.g.*, track and rails. Plaintiff depreciates these items by the use of retirement-replacement-betterment method of depreciation (herein referred to as RR&B method). Recently, we had occasion to review the definition and application of the RR&B method in *Chicago, Burlington & Quincy R.R.* v. *United States*, 197 Ct. Cl. 264, 455 F. 2d 993 (1972), *cert. granted*, 409 U.S. — (1972). Consequently, we will not repeat that discussion except to the extent necessary to the decision in this case.

The basis adjustment regulation upon which taxpayer asserts its offset was promulgated at the behest of Congress when the predecessor to section 1017 was made a permanent provision in 1951.[2] It would be difficult to imagine a broader delegation of the legislative prerogative than the authority granted to the Secretary in this instance:

> SEC. 1017. DISCHARGE OF INDEBTEDNESS.
>
> Where any amount is excluded from gross income under section 108(a) (relating to income from discharge of indebtedness) on account of the discharge of indebtedness the whole or a part of the amount so excluded from gross income shall be applied in reduction of the basis of *any* property held (whether before or after the time of the discharge) by the taxpayer during any portion of the taxable year in which such discharge occurred. *The amount to be so applied* (not in excess of the amount so excluded from gross income, reduced by the amount of

[2] Revenue Act of 1951, ch. 521, § 304, 65 Stat. 452.

> any deduction disallowed under section 108(a)) *and the particular properties to which the reduction shall be allocated, shall be determined under regulations (prescribed by the Secretary or his delegate) in effect at the time of the filing of the consent by the taxpayer referred to in section 108(a)* * * *. [Emphasis added.]

The anticipated amendment to the regulation was promulgated on April 2, 1953,[3] and is represented in applicable part by the current regulation § 1.1017-1(b)(7):

> Any reduction in basis which remains to be taken (by reason of an exclusion from gross income under section 108(a)) after the application of paragraph (a)(1) of this section *shall be applied first against property of a character subject to the allowance for depreciation under section 167* * * *. [Emphasis added.]

There is no doubt that the RR&B method of accounting is an acceptable method for depreciating property under section 167 of the Code, and defendant conceded that fact in oral argument. Approval of this method of accounting by the Internal Revenue Service has been an established fact at least since 1940 when the Seventh Circuit decided *Chicago & North Western Ry.* v. *Commissioner*.[4] *The Boston & Maine R.R.* v. *Commissioner*[5] case, decided three and one-half months after the above-quoted regulation was promulgated, again approved this method as an acceptable method under the provisions of the predecessor to section 167. Additionally, in Revenue Ruling 67-22, the Commissioner stated that "both the railroad industry and the Internal Revenue Service use 'retirement method' to mean a method of accounting for depreciation."[6]

That would seem to end the matter. Since it is undisputed that the taxpayer's RR&B property is of the "character subject to the allowance for depreciation under section 167," the basis of such property is qualified for reduction under section 1017.

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[3] T.D. 6003 (1953 CUM. BULL. 24) (Treas. Regs. 111 (1939 Code), § 29.113(b)(3)-1(G)).

[4] 114 F. 2d 882 (7th Cir. 1940), *cert. denied*, 312 U.S. 692 (1941). In this decision, it was the Government that relied on the method as the proper method of depreciation.

[5] 206 F. 2d 617 (1st Cir. 1953).

[6] 1967-1 CUM. BULL. 52.

However, defendant would have us re-write its regulation to differentiate between ratably and non-ratably depreciable property, both of which are of a "character subject to the allowance for depreciation under section 167." The Government contends that while the RR&B method is an appropriate method for use under section 167 in other circumstances, the allowance of plaintiff's claimed reduction in the basis of RR&B property would be contrary to the intent of Congress as revealed in the Senate Report accompanying the Revenue Act of 1951. The Senate Report [7] states in pertinent part:

> The Secretary of the Treasury has authority under section 113(b)(3) [section 1017 of the 1954 Code] to prescribe regulations which will set forth rules under which the adjustment to basis shall be made * * *. In order to assure that the exclusion of income by operation of section 22(b)(9) [section 108(a) of the 1954 Code] may result only in a temporary postponement of the tax liability, your committee understands that the Secretary of the Treasury will require by regulations that, after adjustment of the basis of certain property acquired with the purchase money indebtedness, whatever reduction in basis of property remains to be taken under section 113(b)(3) will be taken, *in general*, against depreciable property or property subject to cost depletion and only as a last resort against nondepreciable property. Thus, in general, it is intended that a reduction in the basis of nondepreciable property will be made only after the exhaustion of depreciable property or property subject to cost depletion. This provision will assure the collection within a reasonable time of the taxes postponed and will, therefore, have no appreciable long-run effect on the revenue. [Emphasis added.]

After a careful reading of the Senate Report, we cannot agree with defendant's contention that Congress clearly intended that the proposed regulation would apply only to ratably depreciable property. Furthermore, we find no support for defendant's argument that the RR&B method was not considered a method of depreciation at that time and was not comprehended by the regulation. It is true that the Senate Committee understood that the regulation would distinguish

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[7] S. REP. No. 781, 82d Cong., 1st Sess. 59-60 (1951-2 CUM. BULL. 458, 500).

between depreciable and non-depreciable property and that Congress intended that a reduction in the basis of nondepreciable property would be made only after the exhaustion of depreciable property. The statement was also made that a regulation containing such a provision would assure the collection of the postponed taxes in a reasonable time and would have no appreciable long-run effect on the revenue. However, no reference whatever was made to non-ratably depreciable property, and there is no indication that the Senate Committee had its attention called to or considered in any way the interpretation of the regulation which defendant now urges upon us.

In contrast to the lack of any expression of the congressional intention with respect to the precise issue before us, we have the very broad delegation of legislative authority to the Secretary of the Treasury under the provisions of section 1017. The regulation in issue is a legislative regulation, which is the statute itself. It is to be differentiated from an interpretative regulation, which is one that rephrases the statute to give it body.[8] The adoption of defendant's interpretation would require a redrafting of the regulation, excluding any reference to section 167. We find nothing in the legislative history which authorizes or requires us to take that action.

In promulgating the regulation, the Internal Revenue Service adopted a shorthand method of dealing with a complex problem. It used a rational approach by the reference to section 167. An amendment of this legislative regulation to conform with defendant's arguments would require congressional hearings, or at least compliance with established Internal Revenue Service procedure for changes in the regulations and a careful weighing of the ramifications of proposed changes on various types of depreciable property.

The defendant argues that except where there is a complete abandonment or retirement of track without replacement, the tax lost as a result of the reduction in the basis of such property will not be recouped. The result, the defendant says, is to thwart the congressional purpose of avoiding an appreciable long-run effect on the revenue. It is true that only a small portion of railroad track or rails is retired every year, but

[8] *See* Griswold, *A Summary of the Regulations Problem*, 54 HARV. L. REV. 398, 401 (1941).

more of this property is retired in some years than others. All of this is contemplated by section 167 for, as the court said in *Boston & Maine R.R.* v. *Commissioner, supra:*

> * * * [T]he underlying theory of the retirement method is that the charges to expense on account of all the items retired or replaced in any particular year are taken as a rough equivalent of what would be a proper depreciation allowance for *all* the working assets of the company for that year. The assumption is that once the system is functioning normally and the retirements are staggered fairly regularly, the charges to expense on account of equipment wearing out or otherwise disappearing from service are spread out and stabilized, and hence will approximate the results under straight-line depreciation. * * *[9]

Long range effects on the revenue are also brought about when there is a reduction in the basis of ratably depreciable property that has a useful life of more than 50 years. We believe that the Treasury had this in mind when it issued the regulation before us. We must also presume that the Treasury knew that RR&B property was of a "character subject to the allowance of depreciation under section 167." After all, the *Chicago & North Western* case had been decided 13 years earlier. *Boston & Maine*, decided a little over 3 months after the regulation was promulgated, was a signal that the regulation would have to be amended if it were to mean something other than what is clearly expressed by its terms. The fact that the regulation has remained unchanged for 19 years is, it seems to us, an indication of an administrative determination that when all the factors involved are considered, the use of the section 167 approach is the best means of carrying out the intent of Congress.

The use of the section 167 approach also gives a degree of certainty in an area where the need for certainty is high. As Professor Eustice points out:

> The dictates of practical administration of the tax laws demand a reasonable degree of certainty in their application, especially where a problem cuts across so many phases of business and personal activity as does the debt cancellation situation.[10]

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[9] 206 F. 2d at 619.

[10] Eustice, *Cancellation of Indebtedness and the Federal Income Tax: a Problem of Creeping Confusion.* 14 TAX L. REV. 225 (1959).

In summary, we hold that the regulation, unamended by the interpretation which defendant advocates, conforms to the intent of Congress. If a line is to be drawn between ratably depreciable property and non-ratably depreciable property, as defendant argues, it would be equally logical and necessary to provide a distinction between short-lived ratably depreciable property and similar property having a very long estimated useful life. In view of the clear and unambiguous language of the regulation, the fact that it has remained unchanged for so many years, and the long history of approval of the RR&B method under section 167 and its predecessors, plaintiff had a right to rely on the regulation according to its terms. Since plaintiff's claim meets the requirements of section 1017, section 167, and the regulation, plaintiff is entitled to the offsets now claimed.

II

Unamortized Debt Discount Carryover

In the 1947 reorganization, plaintiff's outstanding common and preferred stocks were eliminated as worthless. The outstanding debt was cancelled and the holders of the several classes of indebtedness received new bonds, preferred and common stock, and cash in satisfaction of their claims against plaintiff. After an audit of plaintiff's tax returns for 1947 and 1948, the Internal Revenue Service allowed the taxpayer to carry over unamortized discount and expense from its old bonds allocated to its new bonds, in the amount of $1,643,610.82. For the years in suit, the amortized deductions amounted to more than $23,000 per year.

As an offset, defendant now urges that the Service's action in allowing the carryover was erroneous. We agree. This issue is governed by our decision in *Chicago, Milwaukee, St. Paul and Pacific R.R.* v. *United States*, 186 Ct. Cl. 250, 404 F. 2d 960 (1968). In that case, we held that issuance expense would be treated as would discount, and this being so, there could be no carryover of debt discount or issuance expense if the maturity value of the new bonds is less than the amount that was received when the old securities were issued.

We also held that when common or preferred stock is substituted for a debt, the principal of the debt is no longer

to be paid at a fixed future date. Therefore, the discount and issuance expense attributable to the issuance of the old debt for which the stock is substituted is not deductible after the substitution is made.

It is established in this case that the net amount which plaintiff received upon the issuance of the old debt obligations that were cancelled in the 1947 reorganization was substantially greater than the total maturity value of the new bonds issued in exchange for the old obligations. In the 1947 reorganization, plaintiff also issued preferred and common stock having a par or stated total value of $120,763,545. Although the value of the stock is not to be computed in determining entitlement to the unamortized discount, computations based on the admission of the parties show that the addition of the value of the stock to the maturity value of the new bonds produces a total which is still considerably less than the amount received for the old bonds. The cash which plaintiff paid for interest due on the old debt in the 1947 reorganization is likewise not to be taken into account, because it was issued in a one-for-one exchange.

As its final argument on this issue, plaintiff urges that we should reconsider our decision in *Chicago, Milwaukee* because it is in possible conflict with *Southwest Grease & Oil Co.* v. *United States*, 308 F. Supp. 107 (1969), modified in part, 435 F. 2d 675 (10th Cir. 1971). We think plaintiff misreads *Southwest*. In that case the taxpayer redeemed outstanding bonds at a premium, whereas here, plaintiff redeemed its old bonds at substantially less than the net amount received when the old bonds were issued. For each $1,000 bond, Southwest gave $1,290 in cash and new bonds. Therefore, deductions were allowed for both the premium and the issuance expense of the old bonds. This is totally different from the instant cases where taxpayer's new debt was substantially *less* than the old debt. The substantially lower new debt extinguished the discount, and as we said in *Chicago, Milwaukee*, "[t]here was nothing left to amortize."

Since the allowance of the carryover of the unamortized discount and expense was erroneous, plaintiff's recovery in

these cases should be reduced by the amount of the erroneous allowances.

III

Original Issue Discount

In its motion for partial summary judgment in *St. Louis No. 1*, plaintiff claimed original issue discount for the years 1955, 1956, 1959, 1960 and 1961. In its reply to defendant's first amended answer in Docket No. 289-65, plaintiff alleged that it was entitled to original issue discount deductions for each of the years 1947 through 1955. Plaintiff now agrees that the issue with respect to the additional years mentioned was determined in defendant's favor by our decision in *St. Louis No. 1*. Therefore, defendant's motion for partial summary judgment on this question should be granted.

Conclusion

Plaintiff's motion for summary judgment on Issue I is granted, and defendant's motion for partial summary judgment on Issues II and III is granted. The cases are remanded to the trial commissioner pursuant to Rule 131(c) for further proceedings consistent with this opinion.

DAVIS, *Judge*, dissenting in part:

I join with the court on "Unamortized Debt Discount Carryover" (Part II) and "Original Issue Discount" (Part III) but diverge on "The Reduction of Basis" (Part I). The latter question is very close. The court relies most heavily on the literal wording of the regulation which can easily be read without strain in the taxpayer's favor, as the court does. The counterforce, for me, is the overall purpose of Congress, in §§ 108 and 1017, not to put off indefinitely the taxation of gain from the reacquisition of corporate indebtedness.

The 1951 Senate Committee report (S. REP. No. 781, 82d Cong., 1st Sess. 59-60, 1951-52 CUM. BULL. 458, 500), quoted in the majority opinion, indicates that the "exclusion of income by operation of section 22(b)(9)" [now § 108(a)] should "result only in a temporary postponement of the tax liability", and that placing the exhaustion of nondepreciable

property after the exhaustion of depreciable property (or property subject to cost depletion) "will assure the collection within a reasonable time of the taxes postponed and will, therefore, have no appreciable, long-run effect on the revenue." Under plaintiff's system of retirement accounting, that goal will not be at all achieved. The taxes postponed will not be collected in substantial measure unless the track and rails are wholly abandoned without replacement (an unlikely event as to any major segment of the road), or the railroad goes out of business (and in the latter case, as defendant points out, the company is unlikely to have any taxable income).[1] In other words, because the replacement of rails and tracks is expensed annually and the railroad does not use depreciation deductions as a means of gradually recouping the cost of those items, the basis-reduction sought by the taxpayer will not have the effect Congress envisaged of simply extending for a reasonable period the taxation of the gain on the reacquisition of the preferred stock, but will rather result in the indefinite postponement of most of the tax on that gain (with a good chance that it will never be taxed).

The court points out, in answer, that in the ratable system of depreciation many properties have a useful life of 50 years or more, hardly a temporary period. But the difference is that in those instances the reduction in basis, under the regulation, would lead at once to a pro rata reduction in the annual depreciation deductions, and thus to a gradual but continuous recovery of the postponed tax. Under plaintiff's view, there would be no such steady (though extended) payment of the tax.

In this light, the wording of the regulation does not seem to me to be decisive. Although we now consider the retirement-replacement-betterment system a general system of tax depreciation, that was not so clear in early 1953 when the regulation was promulgated. The broad language

[1] For its track and rails, the plaintiff does not reduce its income tax by depreciation deductions (which, of course, are intimately related to the basis of the property being depreciated) but by full deductions for replacements as if they are repairs (and for retirement if the property is permanently retired without replacement). The calculation of the replacement deductions has no necessary connection with the basis of the particular property; a reduction in basis under the regulation will therefore not reduce the allowable deductions.

of *Boston & Maine R.R.* v. *Commissioner*, 206 F. 2d 617 (C.A. 1, 1953), was not yet on the books, and in the litigation of that case the Revenue Service obviously did not consider the retirement system a method of depreciation for all tax purposes. True, *Chicago & North Western Ry.* v. *Commissioner*, 114 F. 2d 882, 885–86 (C.A. 7, 1940), *cert. denied*, 312 U.S. 692 (1941), had accepted, over the railroad's protest, the Service's designation of the retirement system as a proper method of computing depreciation deductions under the predecessor of § 167, but that did not necessarily mean that rails and tracks were "property of a character subject to the allowance for depreciation" (the terms of the regulation now involved). There could be different characterizations for different purposes. The Service may have been thoughtless in letting this language remain unqualified after the *Boston & Maine* opinion, but that neglect does not override, in my opinion, the indications that neither the Congress nor the Treasury expected the regulation to be applied as plaintiff would have it.

Nor does it not seem to me stretching the words too far to exclude (because the purpose so requires) the plaintiff's replacement system for rails and track. The literal language is not that compelling or rigid. It is possible, in this setting, to read a "reduction in basis" to be applied "first against property of a character subject to the allowance for depreciation under section 167" as limited to property the basis of which is significant in the computation of the depreciation deduction and, conversely, as designating replaced property as not "of a character subject to the allowance for depreciation."

In sum, I deem fulfillment of the legislative goal in this particular context as more important than adherence to the normal understanding, in other contexts, of the general language of the regulation, and believe that there is an acceptable reading of the regulation which advances rather than negates the Congressional aim.

NICHOLS, *Judge*, joins in the foregoing dissenting opinion.

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In the United States Court of Claims

No. 289-65

No. 303-66

(Decided July 14, 1971)

ST. LOUIS-SAN FRANCISCO RAILWAY COMPANY v. THE UNITED STATES

George K. Dunham, for plaintiff. *Robert T. Molloy*, attorney of record. *George E. Bailey* and *Robert E. Simpson*, of counsel.

E. Alan Moorhouse, with whom was *Assistant Attorney General Johnnie M. Walker*, for defendant.

Before COWEN, *Chief Judge*, LARAMORE, DURFEE, DAVIS, COLLINS, SKELTON, and NICHOLS, *Judges*.

ON PLAINTIFF'S MOTION FOR SUMMARY JUDGMENT RESPECTING THE DEBT DISCOUNT ISSUE AND DEFENDANT'S CROSS MOTION FOR PARTIAL SUMMARY JUDGMENT

COWEN, *Chief Judge*, delivered the opinion of the court:

These cases come before the court on cross-motions for partial summary judgment. Plaintiff is seeking tax refunds for the years of 1953 through 1961. At issue in this proceeding are the years 1955 through 1961. The main question before us now is the troublesome one of the existence and measurement of debt discount when a corporation exchanges new debt obligations for its outstanding debt obligations and its outstanding stock. Since two exchanges are involved, we will consider each separately before discussing the other issues raised in the parties' motions.

I

The 1947 Reorganization

In 1947 plaintiff St. Louis-San Francisco Railway Company underwent a reorganization pursuant to Section 77 of the Bankruptcy Act.[1] Under the plan adopted, plaintiff exchanged new stock, new bonds, and cash for outstanding bank loans, bonds, and accrued interest.[2] Before the exchange, the face value of this outstanding debt and interest totaled $363,789,651. Plaintiff gave up in the exchange securities having a maturity value and a par value of $244,856,494. The aggregate maturity value of the new bonds totaled $120,935,000, and their market value, as established by New York Stock Exchange quotations, totaled $91,866,411. A schedule of the reorganized company shows that in no instance did the face value of the bonds issued exceed the principal amount of the old debt. See *McCullough* v. *United States*, 170 Ct. Cl. 1, 24–25, 344 F. 2d 383, *cert. denied*, 382 U.S. 901 (1965). Plaintiff tells us that the market value of the old debt equaled $91,866,411. The figure was apparently computed on plaintiff's assumption that fair market value equivalents were exchanged.

Plaintiff contends that it is entitled to amortize the difference between the maturity value of the new bonds and the fair market value of old debt as debt discount. This difference, according to plaintiff, would be $29,068,689, amortizable over the life of the bonds. Plaintiff relies on Treasury Regulation 1.163–3 and *American Smelting & Ref. Co.* v. *United States*, 130 F. 2d 883 (3rd Cir. 1942). In the alternative, plaintiff argues that a trial would be necessary if we adhere to our decisions in *Erie Lackawanna R.R.* v. *United States*, 190 Ct. Cl. 682, 422 F. 2d 425 (1970) and *Missouri Pac. R.R.* v. *United States*, 192 Ct. Cl. 318, 427 F. 2d 727 (1970), *modified on reconsideration*, 193 Ct. Cl. 257, 433 F. 2d 1324 (1970), *cert. denied*, 39 U.S.L. WEEK 3486 (May 3, 1971).

On the other hand, defendant says that fair market value is irrelevant when the corporation exchanges its own debt

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[1] Plaintiff is an accrual basis taxpayer for the years in question.

[2] Claims of the common and preferred stockholders and unsecured creditors were eliminated from the capital structure as worthless.

obligations. Defendant further contends that no trial is necessary, because the undisputed facts establish that no discount arose in the exchange. For both arguments, defendant relies on *Missouri Pacific*, *supra*.

After a review of our decisions in *Erie Lackawanna* and *Missouri Pacific*, we find no reason to change the rules set forth in those cases with respect to the existence and measurement of debt discount when a corporation issues new bonds in exchange for its outstanding debt. In this case, the plaintiff engaged in a reorganization—a recapitalization in which no new capital or assets were added. The secured creditors received new bonds, preferred stock, common stock and cash. The maturity value of the new bonds was less than the face value of the old bonds.

In *Missouri Pacific*, *supra*, we held contrary to the position now taken by plaintiff with reference to the use of fair market value for measuring debt discount. In that case, we said "The fact that the fair market value of the old bonds may be less than the face value of the new bonds can in no way reduce the amount of value originally paid to plaintiff for the old securities." 192 Ct. Cl. at 324, 427 F. 2d at 731. Applying the rule announced in that case, we find that no debt discount arose in the 1947 reorganization, because the maturity value of the new debt did not exceed the maturity value of the old debt. There is no dispute about that fact and thus no trial is necessary. Since plaintiff incurred no discount in the issuance of the new bonds in the 1947 reorganization, it is entitled to no deductions for the claimed discounts during the years in suit.[3]

II

The 1956 Exchange

In 1956 plaintiff exchanged Series A, five percent Income Debentures bearing a maturity date of January 1, 2006, plus cash and common stock for its outstanding Series A, five percent Preferred Stock, issued in the 1947 reorganization.

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[3] On the assumption that the bonds issued in 1947 were issued at a discount, plaintiff makes certain additional claims. However, we need not consider these, because plaintiff concedes (page 26 of its Reply Brief) that a decision that the bonds were not issued at a discount precludes recovery on the additional claims.

For each $100 par value share of preferred stock surrendered, the holders of the preferred stock received a $100 maturity value Series A Debenture, one quarter share of common stock, and cash amounting to the unpaid portion of the dividend on the preferred stock.

In the aggregate, plaintiff exchanged debentures having a face value of $33,129,000 and 82,823 shares of no par common stock for 331,290 shares of preferred stock which had a total par value of $33,129,000. The market value of the preferred stock, based on New York Stock Exchange quotations, averaged $22,908,148.35 over the period of the exchange. After the exchange was completed, the preferred stock was cancelled and retired.

This transaction was considered by the Internal Revenue Service a reorganization under Section 368(a)(1) of the Internal Revenue Code of 1954—a recapitalization under section 368(a)(1)(E).

In claiming that the 1956 exchange gave rise to amortizable debt discount, plaintiff's primary contention is that the fair market value of the preferred stock ($22,908,148.35) subtracted from the maturity value of the debentures ($33,129,000) is the measurement of debt discount. Thus, plaintiff has computed an amortizable discount of $10,220,851.65.

Plaintiff does not contend that the maturity value of the debentures issued in 1956 exceeded the amount it received when it issued the preferred stock in the 1947 reorganization. Indeed, the facts show that in the 1947 reorganization, plaintiff issued the preferred stock (received in the 1956 exchange), plus common stock and two issues of new bonds having a combined maturity, par, or stated value of approximately $244,856,000 in satisfaction of claims totaling $363,789,000—an amount which exceeded the par and stated value of the stock and bonds issued in 1947 by more than $100,000,000.

The question as to whether original debt discount arises when there is an exchange of debt for equity has been before the court twice in recent years. In *Erie Lackawanna*, we rejected the use of fair market value as a determinative measurement of debt discount when bonds were exchanged for preferred stock. The key element in that case was the *value*

to the corporation of the stock received in the exchange and that value was what had been paid in for the stock. Since the preferred stock in that case had been issued in exchange for the cancellation of debt equal to the par value of the stock, we held that when $100 par value shares were exchanged for $100 maturity value debentures, equivalents had been exchanged and no discount could be said to arise.

In *Missouri Pacific*, 192 Ct. Cl. 318, 427 F. 2d 727 (1970), where bonds were exchanged for stock, we adhered to our decision in *Erie Lackawanna* by stating that when bonds are issued in exchange for stock, debt discount is to be measured by the difference between the face value of the new bonds and the amount originally paid for the stock. On reconsideration (193 Ct. Cl. 257, 433 F. 2d 1324 (1970)), we further refined the measurement by deciding that the amount originally paid in for the stock was the floor in computing debt discount but that the stock could have a greater value in the eyes of the corporation. This greater value was to be determined only after consideration of relevant information, including the market value of the stock, the financial conditions of the taxpayer at the time of the exchange, profit prospects, and expert opinion.

Plaintiff has argued that if we adhere to our decision on reconsideration in *Missouri Pacific*, *supra*, and reject the use of fair market value in determining debt discount, we should order a trial to determine the amount actually paid in for the preferred stock. We again reject the fair market value of the preferred stock in this type of transaction as determinative of the value of the shares to the corporation.

However, no trial is needed, because it is established here, as in *Erie Lackawanna*, that there was an exchange of equals, and as in *Erie Lackawanna*, plaintiff in the 1956 exchange got back one $100 par value share of preferred stock for each $100 debenture given up. Accordingly, plaintiff is entitled to no deduction on account of a claimed discount arising out of the 1956 exchange.

We would reach the same result by holding that the value to plaintiff of the preferred stock, received in exchange for the debentures, was significantly greater than what was initially paid in for the stock or its market value as shown

by stock market quotations at the time of the exchange. In *Missouri Pacific* we said that all relevant factors, including the financial condition of the corporation, should be considered. The plaintiff reported to its shareholders that the exchange would increase its after-tax earnings by over $800,000 per year, without considering any saving due to a determination that it incurred debt discount. Considering this factor, we think that a receipt of stock that increased plaintiff's after-tax earnings by more than $800,000 per year cannot be said to be worth less than the face value of the bonds exchanged for the stock.

Plaintiff makes an additional argument with respect to the common stock, which in addition to the debentures, was exchanged for the preferred stock in the 1956 transaction. Plaintiff says that if it is assumed that each share of the preferred stock had a value of $100, plaintiff incurred debt discount in the amount of the value of the common stock given up in the exchange. Thus, plaintiff contends that if each share of common stock was worth $10, the debt discount should be computed by multiplying the total number of shares of common stock by $10.

Wholly apart from our alternate holding on the 1956 transaction, we find that this contention is without merit. In *Missouri Pacific*, we eliminated the value of new stock which, in addition to bonds and notes, was given in exchange for the corporation's outstanding debt securities and stock from consideration in determining debt discount, 192 Ct. Cl. at 321, n. 4, 427 F. 2d at 729, n. 4. In an analogous situation, we ignored the issuance of preferred stock in determining whether there was a carry-over of debt discount and compared only the maturity value of new bonds and cash with the face value of the old bonds given up in the exchange. *Chicago, Milwaukee R.R.* v. *United States*, 186 Ct. Cl. 250, 263, 404 F. 2d 960, 967 (1968).

Common stock is not a fixed debt obligation, and the plaintiff made no definite obligation for the future by issuing those shares.

In addition, it is very difficult to assume that the preferred stockholders who surrendered their preferred shares in 1956 for the debentures believed, or had any reason to believe,

that they were realizing additional interest income through the exchange (because of a debt discount due to the issuance of the common stock). The taxpayer cannot alter or repudiate its bargain to the detriment of the other side of the exchange, at this late date, in order to obtain a tax advantage for itself. *Cf. Bethlehem Steel Corp* v. *United States*, 193 Ct. Cl. 459, 434 F. 2d 1357 (Dec. 11, 1970); *Commissioner* v. *Danielson*, 378 F. 2d 771, 775 (3rd Cir.), *cert. denied*, 389 U.S. 858 (1967).

III

The Reacquisition of Debentures

In 1959, 1960, and 1962,[4] plaintiff reacquired some of the debentures it issued in 1956 for preferred stock. The Internal Revenue Service on audit determined that plaintiff realized a gain on these transactions. The gain was computed on the basis of the maturity value of the debentures less retirement costs and unamortized issuance expense. The plaintiff elected to have these gains excluded from income under section 108(a) and signed Treasury Consent Forms 982 to have the tax basis of its property reduced pursuant to section 1017 by the amount of the gains so excluded from income.[5] In the consent, plaintiff requested that the gain, if

[4] The issues relating to 1962 are based on a carryback loss from 1962 to 1961 and are included in plaintiff's 1961 refund claim.

[5] Sections 108 and 1017 read:

"§ 108. INCOME FROM DISCHARGE OF INDEBTEDNESS

(a) *Special rule of exclusion.*—No amount shall be included in gross income by reason of the discharge, in whole or in part, within the taxable year, of any indebtedness for which the taxpayer is liable, or subject to which the taxpayer holds property, if—

(1) the indebtedness was incurred or assumed—

(A) by a corporation, or

(B) by an individual in connection with property used in his trade or business, and

(2) such taxpayer makes and files a consent to the regulations prescribed under section 1017 (relating to adjustment of basis) then in effect at such time and in such manner as the Secretary or his delegate by regulations prescribes.

In such case, the amount of any income of such taxpayer attributable to any unamortized premium (computed as of the first day of the taxable year in which such discharge occurred) with respect to such indebtedness shall not be included in gross income, and the amount of the deduction attributable to any unamortized discount (computed as of the first day of the taxable year in which such discharge occurred) with respect to such indebtedness shall not be allowed as a deduction."

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Footnote continued on p. 8.

any, reduce the basis of the preferred stock acquired through the issuance of the debentures. The Commissioner of Internal Revenue refused and reduced the basis of plaintiff's property subject to ratable depreciation. The Commissioner did not reduce the basis of plaintiff's property which was subject to the retirement-replacement method of depreciation.

Plaintiff first argues that the issue price of the debentures controls the computation of gain. We agree. The actual issue price, the value of what plaintiff received for the debentures, controls any determination of gain on the cancellation of indebtedness. Treas. Reg. 1.61-12(c); *United States* v. *Kirby Lumber Co.*, 284 U.S. 1 (1931); *Fashion Park, Inc.* 21 T.C. 600 (1954).

However, we have already found that the issue price of the bonds was their maturity value. The value of the stock received by the plaintiff was equivalent to the maturity value of the bonds. Therefore, the Service properly computed the gain on the cancellation of indebtedness.

Plaintiff next argues that these gains should be applied to reduce plaintiff's basis in the preferred stock, the specific property for which the debentures were issued. Treas. Reg. 1.1017-1(a)(1). However, section 1017 clearly requires that the property be held or acquired during the tax year the income is realized. Here the preferred stock was no longer in existence for the years 1959, 1960, and 1962, because it was cancelled or retired immediately after the completion of the 1956 exchange.

Plaintiff's third contention on this issue is that the Commissioner of Internal Revenue erred in failing to reduce the

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Footnote 5—Continued

"§ 1017. DISCHARGE OF INDEBTEDNESS

Where any amount is excluded from gross income under section 108(a) (relating to income from discharge of indebtedness) on account of the discharge of indebtedness the whole or a part of the amount so excluded from gross income shall be applied in reduction of the basis of any property held (whether before or after the time of the discharge) by the taxpayer during any portion of the taxable year in which such discharge occurred. The amount to be so applied (not in excess of the amount so excluded from gross income, reduced by the amount of any deduction disallowed under section 108(a)) and the particular properties to which the reduction shall be allocated, shall be determined under regulations (prescribed by the Secretary or his delegate) in effect at the time of the filing of the consent by the taxpayer referred to in section 108(a). The reduction shall be made as of the first day of the taxable year in which the discharge occurred, except in the case of property not held by the taxpayer on such first day, in which case it shall take effect as of the time the holding of the taxpayer began."

tax basis of all depreciable property owned by it, as required by Reg. 1.1017-1 (b) (7). It is contended that the retirement-replacement method of accounting (which plaintiff uses) is a form of depreciation. Therefore, plaintiff maintains that the Commissioner erred in reducing only the basis of property subject to ratable depreciation.

Defendant counters with two arguments—one attacking the claim on substantive grounds and the other alleging a procedural defect. We do not reach the substantive issue because we find, as defendant contends, that plaintiff did not assert this ground for recovery in its administrative claim for refund and thus cannot now raise it. Section 7422; *United States* v. *Felt & Tarrant Mfg. Co.*, 283 U.S. 269 (1931); *Union Pac. R.R.* v. *United States*, 182 Ct. Cl. 103, 389 F. 2d 437 (1968).

In its claim for refund before the Commissioner of Internal Revenue for 1961 (which is representative), plaintiff sought:

> In each of the aforesaid years taxpayer filed Consent Form 982, electing to exclude the alleged profit set forth above under Section 108(a) and to reduce the basis of property under Section 1017 of the Code. In said Consent, taxpayer stated that it did not concede that the issue price of the debentures was equivalent to the face amount thereof. Taxpayer further requested that the gain, if any, resulting from the acquisition of the Debentures, as finally determined by agreement with the Internal Revenue Service or by a court of competent jurisdiction, should be applied to reduce basis of the specific property acquired; i.e., the Preferred Stock. The Examining Agent refused to reduce the basis of the specific property acquired as requested by taxpayer and, in lieu thereof, applied the general rule and reduced the basis of all of taxpayer's depreciable property to the extent of the amounts of "profit" set forth above. As a result of such reduction in basis, the Examining Agent disallowed deductions for depreciation as follows:
>
> | | |
> |---|---|
> | 1959 | $9,367.70 |
> | 1960 | 9,314.09 |
> | 1961 | 7,949.38 |
> | 1962 | 21,521.89 |
>
> It is the contention of taxpayer that the action of the Examining Agent as explained above was erroneous,

> and that it is entitled to the deductions for depreciation improperly disallowed as aforesaid. * * *

A careful reading of the claim for refund shows that plaintiff asserted that the error of the Internal Revenue Service was its refusal to reduce the basis of the specific property acquired, *i.e.*, the preferred stock, and that the reduction in the basis of "all of plaintiff's depreciable property" to the extent of the profit plaintiff made on the acquisition of the debentures resulted in an improper disallowance of deductions for depreciation. This is the only ground of complaint; there is no suggestion that the Internal Revenue Service erred in reducing the basis of some but not all of plaintiff's depreciable property, or more specifically that the Service erred in not reducing the basis of plaintiff's property subject to the retirement-replacement method of depreciation. In our opinion, the allegations in the claim for refund were insufficient to call the Commissioner's attention to the potential ground for recovery now urged upon us, or to state the facts which would enable the Commissioner to discover for himself and correct what is now claimed to be erroneous action.

It is not determinative of the issue, but the fact that this ground for recovery is not mentioned or referred to in plaintiff's petition is an indication that it was not included in the claim for refund.

The reasons for requiring a ground for refund to be raised first before the Internal Revenue Service were explained in *Union Pac. R.R.* v. *United States*, *supra:*

> It is an undisputed general rule that a ground for refund neither specifically raised by, nor comprised within the general language of, a timely formal or informal application for refund to the Internal Revenue Service cannot be considered by a court in which a suit for refund is subsequently initiated. * * * The rule that a taxpayer cannot present one ground for refund in its claim and a different ground in its petition is designed both to prevent surprise and to give adequate notice to the Service of the nature of the claim and the specific facts upon which it is predicated, thereby permitting an administrative investigation and determination. * * * In addition, the Commissioner is provided with an opportunity to correct any errors, and if disagreement remains, to limit the scope of any ensuing

> litigation to those issues which have been examined and which he is willing to defend. * * * (182 Ct. Cl. at 108, 389 F. 2d at 442) [citations omitted]

Therefore, as a result of the omission in plaintiff's refund claim, the claim cannot now be considered.

IV

Plaintiff's Alternative Contention on the Debt Discount Issue

Plaintiff's final argument is that if it should be denied the right to amortize the debt discount it claims with respect to the 1947 and 1956 transactions, it should nevertheless be permitted to add the claimed debt discount to the cost basis of its depreciable property. The entire argument is predicated on the assumption that plaintiff actually incurred debt discount in the transactions mentioned. Since we have held to the contrary, this claim must also be denied.

V

Conclusion

For the reasons stated above, plaintiff's motion for partial summary judgment is denied. Defendant's motion for partial summary judgment is granted, and to the extent that plaintiff's claims are covered by the foregoing opinion, such claims in plaintiff's petitions are hereby dismissed.

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